INDEX

	PAGE
Opinions Below	1
Jurisdiction of the Court	2
Statute and Rule Involved	2
Questions Presented	3
Statement	3
Argument	5

List of Authorities

Cases

Fischman v. Raytheon Mfg. Co., 188 F. 2d 783 (2d Cir. 1951)	7
Joseph v. Farnsworth Radio & Television Corp., 99 F. Supp. 701 (S. D. N. Y. 1951)	7
McManus v. Jessup & Moore Paper Co., Civil No. 8015 (D. C. E. D. Pa. 1948)	5

Statutes and Rule

15 U. S. C. § 77q(a)	7
15 U. S. C. § 78j(b)	2, 3, 7
15 U. S. C. § 78o(c)	7
15 U. S. C. § 78aa	2n
28 U. S. C. § 1254(1)	2
Rule X-10B-5 of SEC, 17 CFR § 240.10b5, 13 F. R. 8183	2, 3, 6, 7

PAGE

Miscellaneous

H. R. 9323 ---------- 6
H. R. Rep. No. 1383, 73d Cong., 2d Sess. ---------- 6
H. R. Rep. No. 1838, 73d Cong., 2d Sess. ---------- 6
SEC Release No. 3230, March 21, 1942 ----------7, App.
SEC Release No. 3634, Dec. 22, 1944 ----------7, App.
Sen. Rep. No. 792, 73d Cong. 2d Sess. ---------- 7
Note, 59 Harv. L. Rev. 769 (1946) ---------- 7
Loss, Securities Regulation (1951), pp. 806-810 ---- 7

IN THE

Supreme Court of the United States

OCTOBER TERM, 1951

No. 693

NAHUM BIRNBAUM, MORRIS J. LUTTERMAN and HANA D. LUTTERMAN, co-partners, doing business under the firm name and style of Birnbaum & Co., suing on their own behalf and on behalf of all similarly situated stockholders of NEWPORT STEEL CORPORATION, and on behalf of NEWPORT STEEL CORPORATION,

Plaintiffs-Petitioners,

against

NEWPORT STEEL CORPORATION, WILPORT COMPANY, C. RUSSELL FELDMANN,

Defendants-Respondents,

and

C. F. STAMM, *et al.*,

Defendants.

BRIEF FOR RESPONDENT WILPORT COMPANY IN OPPOSITION

Opinions Below

The opinions below are reported at 98 F. Supp. 506 (S. D. N. Y. 1951, S. H. Kaufman, D. J.) and 193 F. 2d 461 (C. A. 2d Cir. Swan, Ch. J., L. Hand and A. N. Hand, Ct. JJ., opinion by A. N. Hand).

Jurisdiction of the Court

The jurisdiction of this Court is invoked under 28 U. S. C. § 1254 (1),* as amended.

Statute and Rule Involved

Section 10(b) of the Securities Exchange Act (15 U. S. C. § 78j (b); 48 Stat. 891) provides:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> • • • • •
>
> "(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors. (June 6, 1934, ch. 404, § 10, 48 Stat. 891.)"

Rule X-10B-5 of the Securities and Exchange Commission (17 CFR § 240.10b-5, 13 F. R. 8183) provided, as of the date of the actions alleged in this complaint:

> "*Employment of manipulative and deceptive devices by any purchaser of a security.* It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud.
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in

* Petitioners cite also 15 U. S. C. § 78aa, but that section relates to the jurisdiction of the federal courts of first instance.

order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security."

Questions Presented

1. The ultimate question here is whether the complaint states a cause of action maintainable in a federal court. Since diversity of citizenship is not even asserted, that question depends in turn on whether the complaint alleged a cause of action arising out of a violation of Rule X-10B-5 of the Securities and Exchange Commission, issued under authority of § 10(b) of the Securities Exchange Act.

2. The question presented as to the proper interpretation of Rule X-10B-5 of the SEC is:

(a) Whether that Rule is directed against fraud upon the purchaser or seller in connection with his purchase or sale of securities, or whether the Rule extends to a broad field of breaches of the fiduciary duties owed by controlling stockholders and officers to other stockholders; and

(b) Specifically, whether the Rule applies for the benefit of minority stockholders whose grievance relates not to their own purchase or sale of stock, but to the rejection of an offer for merger of the corporation and a sale of his own stock by the controlling stockholder to third persons.

Statement

The defendants' motions (R. 30-32, 34), granted below (R. 63-64, 77), tested the sufficiency of the complaint to support federal jurisdiction.

With the correction set out beneath, petitioners' summary of the allegations of the complaint (Petition, pp. 4-6) appears to be adequate for present purposes. (A better summary, however, is that of the Court of Appeals, R. 70-72.)

In the next-to-last paragraph of their statement (Petition, p. 6), petitioners assert that the rejection of an offer for merger of Newport Steel Corporation, and a sale of the controlling stockholder's shares, were "effected * * * by false and misleading statements sent through the mails to the Newport shareholders * * *." On the contrary, the complaint shows that these communications played no part in effecting either the rejection or the sale complained of. (See R. 9-10, 13-14, 20-27.) Both the rejection and the sale involved third persons, not purchases or sales by the complaining minority stockholders (R. 8), and the communications in each instance related to what had already happened. (See R. 20-24, 26-27.)

In addition, petitioners' statement (p. 6) of the holdings of the courts below is, we think, likely to be misleading. It suggests that the courts below decided that the allegations of fraud were adequate to meet the requirements of Rule X-10B-5, except for the sole difficulty that plaintiffs were neither purchasers nor sellers. On the contrary, the district court made clear that it was not passing on the adequacy of the complaint as alleging fraud, saying: "Even if it be assumed, without deciding, that the complaint alleges facts which amount to a fraud upon the minority stockholders of Newport, plaintiffs may not have their remedy in this court, * * *." (R. 61.) The court then proceeded to base its decision on its construction of SEC Rule X-10B-5 as not intended to cover claimed wrongs of minority stockholders arising out of something other than their purchases or sales of stock (R. 61-62). The Court of Appeals expressed itself as "in accord with the district court's interpretation of the Rule" (R. 72) in this respect, without discussing the adequacy of the allegations as showing fraud or a scheme to defraud within the requirements of the Rule. The area of law to which

the complaint relates is the area of the obligation of controlling stockholders and officers (a) as to utilization of corporate opportunities or (b) in the sale of their control to outsiders. The only question passed upon by the courts below was the question of the extent to which Rule X-10B-5 applied to that area in a situation where the complaining stockholders had neither bought nor sold stock as a result of the actions complained of. The conclusion of all four judges was that the machinery designed for control of security-markets manipulation and frauds on purchasers and sellers of securities was not intended to be extended to stockholder suits of that type.

Argument

1. *There is no conflict among the Courts of Appeals.* The decision below was the unanimous decision of the Court of Appeals for the Second Circuit, Judges L. Hand, A. N. Hand and Swan sitting. It affirmed the judgment of the district court. No other Court of Appeals than that for the Second Circuit has been found to have passed on the point here involved. In their effort to show conflict, petitioners have been able to cite as against this unanimous decision of one of the foremost Courts of Appeals only a single unreported decision of a district court—*McManus* v. *Jessup & Moore Paper Co.*, Civil No. 8015, (D. C. E. D. Pa. 1948), in which no opinion was written. The complaint there alleged that plaintiff also invoked "the ancillary jurisdiction of this court with respect to matters and proceedings in bankruptcy" (Complaint, par. 1(d)). Plaintiffs' brief stated that "Relief was sought against a threatened violation of a plan of reorganization approved by this court under Section 77B of the Bankrupcty Act * * *." (Plaintiffs' Brief, p. 3.) Therefore the basis of even that single case is uncertain. Clearly it provides no adequate basis for an assertion of conflict among the Circuits.

2. *There is no important question of federal law which needs to be settled by this Court.* The question involved in this case relates primarily to the interpretation of an

administrative rule: Rule X-10B-5 of the Securities and Exchange Commission.

It is true that the Rule interpreted uses some of the language of the statute which gave the agency its rule-making power. However, the courts below, in interpreting the language as they did, relied in large part on the agency's own statements of purpose and its general scheme of control. (R. 61-62, 74.) If under the present statutory language the administrative rule had explicitly covered the situation here involved or expressly provided what petitioners contend, then the matter of the statutory coverage would be in issue. That is not the present case. The construction by this Court of the statute may well wait until the issue is presented by the Commission's exercise of its rule-making power in such a way as to call for a determination of the limits of the statutory authorization.

3. *The court below was right.*

A. In the absence of any authority in support of their position, petitioners fall back upon a general discussion of the purposes of the statute, with a number of sweeping conclusions as to its remedial objectives to protect investors.* If these sweeping generalizations were to be applied literally the Act would have to be construed as designed to protect investors from any wrong at the hands of "insiders", however remote the wrong from security manipulation or inducing purchases and sales.

The cogent opinion of the Court of Appeals furnishes the best answer to petitioners' contention as to statutory purposes. (See R. 73-75.) In connection with the purposes of the Rule and Statute, and of § 10(b) in particular

* It is interesting to note that petitioners, in their broad statements as to a Congressional purpose to reach breaches of fiduciary responsibilities by corporate fiduciaries, cite (see Petition, p. 9 n) H. R. Rep. No. 1383, 73d Cong., 2d Sess. That report, however, was to accompany H. R. 9323, a bill which did not contain the provision that became § 10(b), so that any such purposes must be related to other provisions, not to this one. See H. R. 9323, 73d Cong., 2d Sess. § 9; also H. R. Rep. No. 1838 (Conference Report) 73 Cong., 2d Sess. at pp. 32-33.

as designed to fill a gap as to fraudulent manipulative devices in the case of *purchase* of securities as well as sale, see SEC Releases No. 3230, March 21, 1942, and No. 3634, December 22, 1944, pertinent parts of which are set out in the appendix; Sen. Rep. No. 792, 73d Cong., 2d Sess. at pages 1-13, 16-18; compare § 10(b) of the Securities Exchange Act and Rule X-10B-5 with § 17(a) of the Securities Act (48 Stat. 84, 15 U. S. C. § 77q (a)) and § 15(c) of the Securities Exchange Act (49 Stat. 1377, 15 U. S. C. § 78 o (c)); see Note, 59 Harv. L. Rev. 769, 770 (1946), cf. *Fischman* v. *Raytheon Mfg. Co.*, 188 F. 2d 783, 787, n. 2 (2d Cir. 1951); Loss, *Securities Regulation* (1951), pp. 806-810. See also *Joseph* v. *Farnsworth Radio & Television Corp.*, 99 F. Supp. 701, 706 (S. D. N. Y. 1951), another case where the decision, like that of the court below in the present case, recognized limitations in the scope of the Rule.

B. Even if what the complaint alleges had amounted to a violation of Rule X-10B-5, it is clear that this was not the cause of damage to petitioners. Clearly whatever damage petitioners claim to have sustained was due either to the failure of the corporation and its officers and directors to consummate a merger with Follansbee Steel Corporation, or to the sale by controlling stockholder Feldmann of his 40% interest in the Newport Steel Corporation to Wilport Company. Except for general allegations of violations of the Rule which refer to matters "more fully set forth hereinafter" or "stated above" or "specified in the preceding paragraphs" (R. 6-7, 12, 13, 16, 17) and which must therefore be related to specific allegations in the remainder of the complaint, the only allegations in the complaint of acts involving use of the mails or other instrumentalities of interstate commerce in violation of Rule X-10B-5 are the allegations of the sending of three communications. The first was a letter from Feldmann telling of the breakoff of negotiations with Follansbee Steel Corporation after that break had taken place. (R. 9-10, 20-21.) The second and third communications were from the new officers of Newport and related to the sale by Feldmann of his stock to Wilport Company. (R. 13-14, 22-24,

26-27.) These also were communications sent after the events they discussed had already taken place. The first letter is claimed to have been false and misleading in that it failed to report a firm offer by Follansbee and Feldmann's personal interest in rejection of that offer. The second and third are alleged to have omitted to state the price paid for the Feldmann stock; and the second also to have omitted a statement of the purpose to make Newport a "captive subsidiary." (R. 9-10, 13-14.) It is not alleged that petitioners took or failed to take any action whatever in reliance on these communications or that they purchased or sold stock in consequence of what was said or omitted in the communications. Obviously the letters had nothing to do with bringing about Feldmann's rejection of one offer and his acceptance of the other out of which any damage to plaintiffs or their corporation arose.

Clearly, therefore, plaintiffs had no cause of action resulting from a violation of the Rule. Even if, *arguendo*, the communications alleged were a fraudulent scheme as that expression is used in Rule X-10B-5, or otherwise within its terms, and even though a breach of the Rule resulting in damage to an individual gives rise to a private cause of action in his favor, the most elastic concept of the scope and purpose of the Act and the Rule will hardly suffice for a construction giving a private cause of action for a breach of the Rule which did not cause any damage to the plaintiff.

Plaintiffs' contention would unjustifiably load upon the federal courts a large proportion of all derivative stockholder litigations.

WHEREFORE, it is urged that the petition be denied.

Respectfully submitted,

A. DONALD MACKINNON
Attorney for Respondent
Wilport Company

REBECCA M. CUTLER,
Of Counsel

May 15, 1952

Appendix

"For Immediate Release Thursday, May 21, 1942

Securities and Exchange Commission
Philadelphia

Securities Exchange Act of 1934
Release No. 3230

The Securities and Exchange Commission today announced the adoption of a rule prohibiting fraud by any person in connection with the purchase of securities. The previously existing rules against fraud in the purchase of securities applied only to brokers and dealers. The new rule closes a loophole in the protections against fraud administered by the Commission by prohibiting individuals or companies from buying securities if they engage in fraud in their purchase. The text of the Commission's action follows: * * *."

"For Immediate Release Friday, December 22, 1944

Securities and Exchange Commission
Philadelphia

Securities Exchange Act of 1934
Release No. 3634

Securities Act of 1933
Release No. 3034

Since the adoption on May 21, 1942 of Rule X-10B-5 pursuant to Sections 10(b) and 23(a) of the Securities Exchange Act of 1934, the Commission has received numerous inquiries as to its extent and application. Generally speaking, this Rule embodies the broad anti-fraud provisions of Section 17(a) of the Securities Act of 1933 but specifically prohibits fraud not only in connection with the sale of securities but also in connection with the purchase of securities. * * *"